

Governmental Accounting Standards Series

EXPOSURE DRAFT (REVISED)

Proposed Statement of the Governmental Accounting Standards Board

Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions

This Exposure Draft of a proposed Statement of Governmental Accounting Standards is issued by the Board for public comment. Written comments should be addressed to:

Director of Research
Project No. 22-2R

Comment Deadline: April 30, 2004



GOVERNMENTAL ACCOUNTING STANDARDS BOARD
OF THE FINANCIAL ACCOUNTING FOUNDATION

ACCOUNTING AND FINANCIAL REPORTING BY EMPLOYERS FOR POSTEMPLOYMENT BENEFITS OTHER THAN PENSIONS

Notice of Request for Written Comments

Deadline for submitting written comments: April 30, 2004

Requirements for written comments. Any individual or organization that wants to provide written comments should do so **no later than April 30**. Comments should be addressed to the Director of Research, Project No. 22-2R. Comments also can be submitted by electronic mail to: director@gasb.org.

OTHER INFORMATION

Public files. Written comments will become part of the Board's public file and will be available for inspection at the Board's offices. Copies of those materials may be obtained for a specified charge.

Orders. Any individual or organization may obtain one copy of this Exposure Draft on request without charge until April 30, 2004, by writing or phoning the GASB. For information on prices for additional copies and copies requested after April 30, please contact the Order Department at the address shown below.

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<p>Notice to Recipients of This Exposure Draft</p>

The Governmental Accounting Standards Board is responsible for developing standards of state and local governmental accounting and financial reporting that will (a) result in useful information for users of financial reports and (b) guide and educate the public, including issuers, auditors, and users of those financial reports.

The due process procedures that we follow before issuing our standards are designed to encourage broad public participation in the standards-setting process. As part of that due process, in February 2003 we issued an Exposure Draft, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*, setting forth proposed standards of accounting and financial reporting, the proposed effective date and method of transition, background information, and an explanation of the basis for the Board's conclusions. Subsequently, we have carefully considered written and oral comments received from constituents regarding those proposals. That process has resulted in a number of proposed revisions that we believe will improve the final standards.

The most significant proposed revision is to eliminate the proposal to exempt employers from measuring and reporting an *implicit rate subsidy* as an other postemployment benefit (OPEB) in certain circumstances. The February 2003 Exposure Draft defined an implicit rate subsidy as the difference between a premium rate charged to retirees for a benefit and the estimated rate that would be applicable to those retirees if that benefit was acquired for them as a separate group—that is, a rate that would reflect retirees' generally higher claims costs. In that Exposure Draft, we proposed that an implicit rate subsidy to retirees resulting from their participation in a healthcare plan covering both active employees and retirees would not be required to be accounted for as OPEB, if the employer did not additionally contribute to the cost of the retirees' benefits in an *explicit* form.

After considering numerous respondent comments received on this issue, we have concluded that the benefits from improved reliability and usefulness of reported financial information about the *potentially significant OPEB costs and obligations* associated with implicit rate subsidies would exceed the cost of producing the information required by this revised proposal. Accordingly, we have decided not to go forward with the proposed exemption. As a result, this proposed Statement generally would require that the projection of retiree benefits be based on claims costs for retirees or on age-adjusted premiums approximating claims costs.

Because the change discussed in the preceding paragraphs would extend the applicability of the accrual-basis accounting and financial reporting requirements of the proposed Statement to additional governments, we are issuing this revised Exposure Draft to provide an additional opportunity for comments on this matter.

Issue: Implicit rate subsidies. The Board has decided *not to go forward* with the proposed exemption from accounting for an implicit rate subsidy to retirees for healthcare benefits as OPEB, if an employer does not make any additional explicit contribution for those benefits. This revised Exposure Draft generally would require all employer contributions, explicit or implicit, to be accounted for as OPEB on an accrual basis. It generally would require that the projection of benefits be based on retiree claims costs, or on age-adjusted premiums approximating claims costs. The use of unadjusted premiums would be permitted in cases where an employer participates in a community-rated plan, to the extent also permitted by Actuarial Standards of Practice.

In addition, employers that use the alternative measurement method would be required to age-adjust premiums when only blended premiums covering active employees and retirees are known. A simplified procedure would be provided for that purpose.

Do you agree with these proposed changes? Why or why not? (See paragraph 13a(2), Exhibit 4 of paragraph 36, and paragraphs 55–60, 101–102, 185, and 195–204 of this revised Exposure Draft for discussion of this issue, including the basis for the Board's conclusions and the alternative view.)

We invite your comments on the changes discussed in the preceding paragraphs. To facilitate an effective analysis of comment letters, it would be most helpful if you explain the *reasons* for your views, including reasons you agree or disagree with the proposed changes, and alternatives that you believe we should consider.

Responses in regard to this revised Exposure Draft will be distributed to the Board and to staff members assigned to this project and will be considered during the Board's deliberations leading to a final Statement. When we are satisfied that all reasonable alternatives have adequately been considered, and modifications have been made when deemed appropriate, a vote will be taken on the Statement. A majority vote is required for adoption.

Related Exposure Draft

In February 2003, the Board also issued a related Exposure Draft, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. The Board has completed redeliberation of issues related to that Exposure Draft and expects to issue a final Statement on plan reporting during the comment and redeliberation period for this revised Exposure Draft on employer reporting. The implicit rate subsidy issue, which is the subject of this reexposure, does not affect the related Exposure Draft.

Other Changes

Other changes in *this* revised Exposure Draft, which also affect the *related* Exposure Draft, are listed in Appendix G, "Summary of Changes to the February 2003 Exposure Draft."

Summary

In addition to pensions, many state and local governmental employers provide *other postemployment benefits* (OPEB) as part of the total compensation offered to attract and retain the services of qualified employees. OPEB includes *postemployment healthcare*, as well as other forms of postemployment benefits (for example, life insurance) when provided separately from a pension plan. This proposed Statement would establish standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities (assets), note disclosures, and, if applicable, required supplementary information (RSI) in the financial reports of state and local governmental employers.

The approach followed in this proposed Statement generally is consistent with the approach adopted in Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, with modifications to reflect differences between pension benefits and OPEB. A related proposed Statement, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* (referred to as the related Statement), issued in February 2003, addresses financial statement and disclosure requirements for OPEB trust funds.

How This Proposed Statement Would Improve Financial Reporting

Postemployment benefits (OPEB as well as pensions) are part of an exchange of salaries and benefits for employee services rendered. Of the total benefits offered by employers to attract and retain qualified employees, some benefits, including salaries and active-employee healthcare, are taken while the employees are in active service, whereas other benefits, including postemployment healthcare and other OPEB, are taken after the employees' services have ended. Nevertheless, both types of benefits constitute compensation for employee services.

From an accrual accounting perspective, the cost of OPEB, like the cost of pension benefits, generally should be associated with the periods in which the exchange occurs, rather than with the periods (often many years later) when benefits are paid or provided. However, in current practice, most OPEB plans are financed on a pay-as-you-go basis, and financial statements generally do not report the financial effects of OPEB until the promised benefits are paid. As a result, current financial reporting generally fails to:

- Recognize the *cost* of benefits in periods when the related services are received by the employer
- Provide information about the *actuarial accrued liabilities* for promised benefits associated with past services and whether and to what extent those benefits have been funded

- Provide information useful in assessing potential demands on the employer's future cash flows.

This proposed Statement would improve the relevance and usefulness of financial reporting by (a) requiring systematic, accrual-basis measurement and recognition of OPEB cost (expense) over a period that approximates employees' years of service and (b) providing information about actuarial accrued liabilities associated with OPEB and whether and to what extent progress is being made in funding the plan.

Summary of Proposed Standards

Measurement (the Parameters)

Employers that participate in *single-employer* or *agent multiple-employer defined benefit* OPEB plans (sole and agent employers) would be required to measure and disclose an amount for annual OPEB cost on the accrual basis of accounting. Annual OPEB cost would be equal to the employer's annual required contribution to the plan (ARC), with certain adjustments if the employer has a net OPEB obligation for past under- or overcontributions.

The ARC would be defined as the employer's required contributions for the year, calculated in accordance with certain parameters, and would include (a) the normal cost for the year and (b) a component for amortization of the total unfunded actuarial accrued liabilities (or funding excess) of the plan over a period not to exceed thirty years. The parameters would include requirements for the frequency and timing of actuarial valuations as well as for the actuarial methods and assumptions that are acceptable for financial reporting. If the methods and assumptions used in determining a plan's funding requirements meet the parameters, the same methods and assumptions would be required for financial reporting by both a plan and its participating employer(s). However, if a plan's method of financing does not meet the parameters (for example, the plan is financed on a pay-as-you-go basis), the parameters would apply, nevertheless, for financial reporting purposes.

For financial reporting purposes, an actuarial valuation would be required at least biennially for OPEB plans with a total membership (including employees in active service, terminated employees who have accumulated benefits but are not yet receiving them, and retired employees and beneficiaries currently receiving benefits) of 200 or more, or at least triennially for plans with a total membership of fewer than 200. The projection of benefits would include all benefits covered by the current *substantive plan* (the plan as understood by the employer and plan members) at the time of each valuation and would take into consideration the pattern of sharing of benefit costs between the employer and plan

members to that point, as well as certain legal or contractual caps on benefits to be provided. The parameters would require that the selection of actuarial assumptions, including the *healthcare cost trend rate* for postemployment health-care plans, be guided by applicable actuarial standards.

Alternative Measurement Method

Employers in single-employer OPEB plans with a total membership of fewer than one hundred would have the option to apply a simplified *alternative measurement method* instead of obtaining actuarial valuations. This alternative method would include the same broad measurement steps as an actuarial valuation (projecting future cash outlays for benefits, discounting projected benefits to present value, and allocating the present value of benefits to periods using an actuarial cost method). However, it would permit simplification of certain assumptions to make the method potentially usable by nonspecialists.

Net OPEB Obligation—Measurement

A net OPEB obligation would be defined as the cumulative difference between annual OPEB cost and the employer's contributions to a plan, including the OPEB liability or asset at transition, if any. (Because retroactive application of the measurement requirements of this proposed Statement would not be required, for most employers the OPEB liability at the beginning of the transition year would be zero.) An employer with a net OPEB obligation would be required to measure annual OPEB cost equal to (a) the ARC, (b) one year's interest on the net OPEB obligation, and (c) an adjustment to the ARC to offset the effect of actuarial amortization of past under- or overcontributions.

Financial Statement Recognition and Disclosure

Sole and agent employers would recognize OPEB expense in an amount equal to annual OPEB cost in government-wide financial statements and in the financial statements of proprietary funds and fiduciary funds from which OPEB contributions are made. OPEB expenditures would be recognized on a modified accrual basis in governmental fund financial statements. Net OPEB obligations, if any, including amounts associated with under- or overcontributions from governmental funds, would be displayed as liabilities (or assets) in government-wide financial statements. Similarly, net OPEB obligations associated with proprietary or fiduciary funds from which contributions are made would be displayed as liabilities (or assets) in the financial statements of those funds.

Employers would be required to disclose descriptive information about each defined benefit OPEB plan in which they participate, including the funding policy followed. In addition, sole and agent employers would be required to disclose information about contributions made in comparison to annual OPEB cost, changes in the net OPEB obligation, the funded status of each plan as of the most recent actuarial valuation date, and the nature of the actuarial valuation process and significant methods and assumptions used. Sole and agent employers also would be required to present as *RSI* a schedule of funding progress for the most recent valuation and the two preceding valuations, accompanied by notes regarding factors that significantly affect the identification of trends in the amounts reported.

Cost-Sharing Employers

Employers participating in *cost-sharing multiple-employer* plans that are administered as formal trusts, or as equivalent arrangements—in which employer contributions to the plan are irrevocable, plan assets are dedicated to providing benefits to retirees and their beneficiaries in accordance with the terms of the plan, and plan assets are legally protected from creditors of the employers or plan administrator—would report as cost-sharing employers. Employers participating in multiple-employer plans that do not meet those criteria instead would be required to apply the requirements of this Statement that are applicable to agent employers.

Cost-sharing employers would be required to recognize OPEB expense/expenditures for their *contractually required contributions* to the plan on the accrual or modified accrual basis, as applicable. Required disclosures would include identification of the way that the contractually required contribution rate is determined (for example, by statute or contract or on an actuarially determined basis). Employers participating in a cost-sharing plan would be required to present as *RSI* schedules of funding progress and employer contributions for the plan as a whole if a plan financial report, prepared in accordance with the related Statement, is not issued and made publicly available and the plan is not included in the financial report of a public employee retirement system or another entity.

Other Guidance

Employers that participate in *defined contribution* OPEB plans would be required to recognize OPEB expense/expenditures for their required contributions to the plan and a liability for unpaid required contributions on the accrual or modified accrual basis, as applicable.

This proposed Statement also includes guidance for employers that finance OPEB as insured benefits (as defined by this Statement) and for special funding situations.

Effective Dates and Transition

This proposed Statement would permit prospective implementation; that is, employers would be permitted to set the beginning net OPEB obligation at zero as of the beginning of the initial year. Implementation would occur in three phases based on a government's total annual revenues in the first fiscal year ending after June 15, 1999. The definitions and cutoff points for that purpose would be the same as those in Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. This proposed Statement would be effective for periods beginning after December 15, 2006, for *phase 1 governments* (those with total annual revenues of \$100 million or more); after December 15, 2007, for *phase 2 governments* (those with total annual revenues of \$10 million or more but less than \$100 million); and after December 15, 2008, for *phase 3 governments* (those with total annual revenues of less than \$10 million). Earlier implementation would be encouraged.

Unless otherwise specified, pronouncements of the GASB apply to financial reports of all state and local governmental entities, including general purpose governments; public benefit corporations and authorities; public employee retirement systems; and public utilities, hospitals and other healthcare providers, and colleges and universities. Paragraphs 4 and 6 discuss the applicability of this Statement.